

Office of Chief Counsel
Internal Revenue Service

memorandum

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to: Chief, Quality Measurement Branch, North Florida District

from: District Counsel, North Florida

subject: Section 6201(d)'s Impact on I.R.P. Information Received with
Respect to Non-filers

Section 6201(d) provides in pertinent part:

"In any court proceeding, if a taxpayer asserts a reasonable dispute with respect to any item of income reported on an information return filed with the Secretary under subpart B or C of part III of sub-chapter A of chapter 61 by a third party and the taxpayer has fully cooperated with the Secretary (including providing, within a reasonable period of time, access to and inspection of all witnesses, information, and documents within the control of the taxpayer as reasonably requested by the Secretary), the Secretary shall have the burden of producing reasonable and probative information concerning such deficiency in addition to such information return."

In essence, Section 6201(d) codifies the Fifth Circuit's holding in Portillo v. Commissioner, 932 F.2d 1128 (5th Cir. 1991). The Court in Portillo refused to uphold the income tax deficiency that resulted from an income adjustment based solely on the Service's receipt of a Form 1099 from a third party payer, when the taxpayer disputed the receipt of that income. The Court held it would not attribute any more credibility to the third party information return than it would to the taxpayer's federal income tax return, which did not include that income reported by the information return in question. The Portillo Court reasoned that the Form 1099 and the taxpayer's federal income tax return were both simply returns filed with the Service by interested parties. The taxpayer has an interest in not reporting the income, and the third party payer has an interest in the deduction he would be entitled to pursuant to the payment of non-employee compensation, evidenced by the Form 1099 filed with the Service. As such, the Portillo Court held that without something more than a third

party information return the Service's assertion of a deficiency would not be upheld, when the taxpayer disputed the receipt of the income reported within a third party information return. Moreover, the Portillo Court held the Service was not entitled to benefit from the burden of proof rules with respect to such a "naked" income adjustment that was unsupported by anything but an unverified third party information return. In sum, I.R.C. § 6201(d) codifies the Portillo Court's holding that the Service must have some probative evidence corroborating a third party information return, if a disputed income adjustment is to be upheld against a cooperative taxpayer.

In a similar case, Smus v. Commissioner, T.C. Memo 1998-386, the Tax Court ruled against the Commissioner where the Service relied solely on the presumption of correctness attributed to our notice of deficiency. The Court refused to allow the Service to rely solely on the burden of proof rules in the face of the taxpayer's dispute with respect to the receipt of income as reported in the notice of deficiency. In the absence of any substantive evidence, the Court in Smus found the Service's asserted deficiency to be arbitrary and held the Service could not rely solely on the burden of proof. Thus, the Smus Court reiterates the position that the courts are unwilling to accept uncorroborated income adjustments in notices of deficiency when the taxpayer has raised a reasonable dispute with respect to the receipt of that income.

Non-filers at first blush would presumably be non-cooperative taxpayers to whom the provisions of § 6201(d) would be inapplicable; however, the Courts have yet to define what such "cooperation" entails and when it must begin. As such, the Service must anticipate that a non-filer's subsequent actions may be considered "cooperation" by the Court, if the government's interest is to be adequately protected in accordance with the provisions of I.R.C. § 6201(d). The Service's failure to anticipate a non-filers later "cooperation" will likely result in the government's concession of income adjustments based upon third party information returns because such evidence corroborating an information return is often no longer available when a dispute as to the correctness of an information return is ultimately raised. Therefore, it falls upon the Service to do something more than simply rely upon a third party information return when asserting income adjustments that are to be included within a notice of deficiency issued to the taxpayer. The following addresses the additional steps the Examination Division needs to undertake when dealing with third party information returns reporting income allegedly paid to a non-filer. The following administrative procedures will not only serve to sustain the validity of the Service's income adjustments against

non-filers, but will also improve the accuracy of such income adjustments against non-filers.

1. The Service needs to first attempt to contact the taxpayer to determine if the taxpayer disputes the receipt of the income reported within the third party information return. If the taxpayer does not dispute receiving the income as reported to the Service by a third party payer, then the Service needs to secure a written acknowledgment from the taxpayer (e.g., a waiver of restrictions on assessment) that affirmatively indicates no dispute of the receipt of income. Upon receipt of this written waiver of assessment from the taxpayer, the Service would then be in a position to assess the deficiency resulting from the unreported income reported within the Form 1099.

2. If the taxpayer does not respond to the Service's attempt to contact him or her, then another attempt should be made to contact the taxpayer. However, this follow up letter to the taxpayer should be sent via certified mail with return receipt requested. Moreover, the Service's agent should keep the receipts associated with this certified mailing to create a record of the taxpayer's receipt of this correspondence. If the taxpayer does not respond to this second certified mailing, then it can be assumed that the taxpayer is disputing the receipt of the income reported on the Form 1099. Thus, verification of the accuracy of the Form 1099 is required and the procedures outlined in the following paragraphs should be followed.

3. Verification of the accuracy of a Form 1099 is required where the taxpayer raises a dispute with respect to the receipt of the income reported in the Form 1099 ("I didn't work for that company that year" or "I didn't make that much from that company that year.") When such a dispute is raised, the Service then needs to contact the third party that filed the information return with the Service. Procedures for contacting the third party payer to verify the accuracy of a Form 1099 are set forth in I.R.M. 21.34(20). In essence, the I.R.M. protocol requires the Service's agent to send a Letter 2645C to the third party payer, which requests verification of the payment to the taxpayer of the amounts reported in the Form 1099. If after following the procedures provided for in I.R.M. 21.34(20) the Service is able to confirm the accuracy of the third party payments to the taxpayer, then the Service can reasonably include an income adjustment within a notice of deficiency based upon such third party information returns and subsequent third party verification. Finally, all verifying documentation obtained from

the third party payer, such as canceled checks, payroll records, or statements from the payer, should be saved to defend the Service's inclusion of the income adjustment in any subsequent litigation.

4. Following inquiries to the third party payers, if the Service receives no response from the third party payer who filed the information returns at issue with the Service, then it falls upon the Service's shoulders to make a determination as to why it has not received a response from the alleged third party payer. Determining why the Service received no such response will require further investigation. Such further investigation should be aimed at independently verifying the taxpayer's receipt of the income, e.g., a bank deposits analysis of the taxpayer's accounts or third party summons. However, if a reasonable dispute has been raised by the taxpayer and the Service is unable to independently verify the taxpayer's receipt of the income and has received no response from the alleged third party payer, then no income adjustment should be included within a notice of deficiency based upon such uncorroborated third party information returns.

Conclusion

The above described administrative procedures will ensure that the Service has obtained information either, corroborating the accuracy of the information contained within third party information returns upon which the Service is basing income adjustments to be included within notices of deficiency, or information that establishes the taxpayer's lack of cooperation with reasonable requests concerning such income adjustments. This information will allow the Service to meet its burden of producing reasonably probative evidence with respect to the income adjustment at issue, or show that the taxpayer has failed to cooperate with reasonable requests to corroborate the correctness of such an income adjustment. In either case, these administrative procedures will allow the government to prevail with respect to contested income adjustments included within notices of deficiency that are based upon third party information returns filed with the Service.

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